

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company)	
)	
)	Docket No. 16-0093
Proposed Rate Increase for Water)	
and Sewer Service)	

**MOTION TO STRIKE PORTIONS OF THE
INITIAL BRIEF OF ILLINOIS AMERICA WATER COMPANY**

NOW COMES the Staff of the Illinois Commerce Commission (“Staff”), by and through their undersigned counsel, pursuant to Section 200.190 of the Illinois Commerce Commission’s Rules of Practice (83 Ill. Adm. Code 200.190), and moves to strike certain portions of the Initial Brief filed by Illinois American Water Company (“IAWC” or the “Company”) on August 31, 2016 as unsupported by record evidence herein, and as contrary to the evidence adduced by IAWC in its own witness testimony. In support of this Motion, Staff states as follows:

I. Introduction

In this proceeding, IAWC presented the expert direct, rebuttal and surrebuttal testimony of Paul R. Moul (IAWC Exs. 10.00, 10.00R, and 10.00SR, respectively) in support of its cost of equity recommendation. Mr. Moul testified that his “company-specific growth analysis...focuses principally upon five-year forecasts of earnings per share growth...” (IAWC Ex. 10.00, 24.) At no point in his direct or subsequent testimony does Mr. Moul – or any other IAWC witness – suggest the DCF growth rate should be

anything other than the five-year forecast he detailed in his direct testimony. Indeed, Mr. Moul unequivocally supported a single stage, constant growth rate analysis, and specifically urged rejection of a non-constant approach. (See, e.g. IAWC Ex. 10.00, 21; IAWC Ex. 10.00R, 25.)

Now, in its Initial Brief and in stark contrast to its testimony, IAWC argues in favor of using a two-stage approach, relying on the suggestion that “IIWC/FEA/CUB used the two-stage FERC model in estimating a return on the market to derive a CAPM market risk premium.” (IAWC IB, 12.) IAWC argues that “[i]f the FERC approach was reliable for this purpose, it is equally reliable for others.” Id. As the sole source of authority for this new position, IAWC cites to Appendix B IIWC/FEA/CUB Exhibit 1.0, 43-44. IAWC’s argument to this effect should be stricken in its entirety as being directly contrary to its own evidence, unsupported by the record, and constituting precisely the sort of “trial by ambush” that the Illinois Supreme Court Rules and Commission Rules of Practice are intended to prevent.

Parties to an administrative hearing have the right to confront the assertions of adverse witnesses. This legal principle is violated where, as here, the Initial Brief of IAWC contains new positions, opinions and analyses, directly contrary to the position taken by IAWC’s own witness and reflected in the record evidence. If IAWC wanted to advance an argument advocating for a two-stage approach, it could and should have been done so through the testimony of its own expert witness. Changing its position is wholly improper in a post-hearing brief, especially where, as here, a party’s new positions, opinions and analyses are contrary to the record evidence propounded by the party itself.

In its Initial Brief, IAWC repeatedly goes outside the record evidence in this case, relying instead upon an order by the Federal Energy Regulatory Commission (“FERC”) – wholly inapplicable to water companies - in an effort to suggest that the Commission

should use a two-stage model to estimate growth rates and that the Commission should give lesser weight to cost of equity recommendations calculated using a Discounted Cash Flow (“DCF”) model than via other methodologies. The contention that adjustments are necessary based on the FERC methodology is wholly unsupported by the record evidence and contrary to the testimony offered by IAWC’s own witness.¹ For these reasons, as set forth in more detail below, parts of IAWC’s Initial Brief (“IB”) should be stricken.

II. Legal Standards

The Public Utilities Act (“Act”) is unequivocal regarding the basis upon which the Illinois Commerce Commission (“Commission”) can render a decision. The Act states, in relevant part:

...any finding, decision or order made by the Commission shall be based *exclusively on the record* for decision in the case, which shall include only the transcript of testimony and exhibits together with all papers and requests filed in the proceeding, including, in contested cases, the documents and information described in Section 10-35 of the Illinois Administrative Procedure Act.

220 ILCS 5/10-103 (emphasis added)

The documents described in Section 10-35 of the Illinois Administrative Procedures Act include:

- (1) All pleadings (including all notices and responses thereto), motions, and rulings.
- (2) All evidence received.
- (3) A statement of matters officially noticed.
- (4) Any offers of proof, objections, and rulings thereon.
- (5) Any proposed findings and exceptions.

¹ While IAWC’s expert makes an ROE recommendation above the average of his DCF/CAPM analyses, he justifies this by suggesting that his Risk Premium and Comparable Earnings analyses suggest that an ROE at the higher end of his recommended range is appropriate. At *no point* does he suggest that the results of a DCF analysis must individually be adjusted upward nor does he suggest that justification for making a recommendation at the higher end of his range stems in whole or in part from consideration of FERC methodology.

- (6) Any decision, opinion, or report by the administrative law judge.
- (7) All staff memoranda or data submitted to the administrative law judge or members of the agency in connection with their consideration of the case that are inconsistent with Section 10-60.
- (8) Any communication prohibited by Section 10-60.

5 ILCS 100/10-35

The Commission must base its factual findings on the evidence and on matters officially noticed ... and ... nothing can be treated as evidence unless it is introduced as evidence and satisfies the threshold evidentiary requirements of admissibility. Village of Montgomery v. Commerce Comm'n, 249 Ill.App.3d 484, 495, 618 N.E.2d 1295 (1993) (internal citations omitted). “The commissioners cannot act on their own information. Their findings must be based on evidence presented in the case, with an opportunity to all parties to know the evidence to be submitted or considered, to cross-examine witnesses, to inspect documents and to offer evidence in explanation or rebuttal, and nothing can be treated as evidence, which is not introduced as such.” Atchison, Topeka & Santa Fe Ry. Co. v. Commerce Comm’n, 335 Ill. 624, 638, 167 N.E. 831, 837 (1929).

Further, Illinois Supreme Court Rules require the disclosure to opposing parties of expert witness testimony, including “the subject matter on which the witness will testify; ... the conclusions and opinions of the witness and the bases therefor; ... the qualifications of the witness; and ... any reports prepared by the witness about the case.” Ill. Sup. Ct. R. 213(f)(3) (effective January 1, 2007). The Commission Rules of Practice take this one step further, authorizing Administrative Law Judges to require parties to pre-file their expert testimony, thereby allowing other parties to review it and respond appropriately. 83 Ill. Adm. Code 200.660. The clear purpose of such rules is to further the administration of justice and prevent trial by ambush. See White v. Garlock Sealing

Technologies, LLC, 373 Ill. App. 3d 309, 326 (4th Dist. 2007); *see also* 83 Ill. Adm. Code 200.660 (“[i]t is the policy of the Commission to encourage the advance submission of testimony and exhibits by all parties and staff witnesses.”) Parties that “lay in the weeds until the briefing stage” deprive opposing parties of their due process rights and impede the Commission’s ability to uphold its obligation to address all properly raised arguments. City of Chicago v. Commerce Comm’n, 264 Ill. App. 3d 403, 409-410 (1st Dist. 1993).

It is well-settled that the Commission must make decisions based on evidence presented at the hearing; the FERC order upon which IAWC relies in its IB is not part of the record and thus cannot properly be introduced at this point in the proceeding. It is fundamental that a decision pursuant to an administrative hearing must be based upon testimony and other evidence received at the hearing and that a conclusion influenced by extraneous considerations must be set aside. Morgan v. United States, 298 U.S. 468 (1936); Des Plaines Currency Exchange, Inc. v. Knight, 29 Ill.2d 244, 247 (1963). Facts, even if conceivably known to the Commission but not put into evidence, will not support a commission decision. Rockwell Lime Co. v. Commerce Comm’n, 373 Ill. 309, 26 N.E.2d 99 (1940). The Commission may take cognizance of facts adduced at other hearings, presumably even hearings by other agencies. However, “the Commission may do so only when such facts are introduced as evidence at a hearing where all parties have an opportunity to be heard.” Knox Motor Service, Inc. v. Commerce Comm’n, 77 Ill.App.3d 590, 597 (4th Dist. 1979)

Moreover, consideration of the new opinions, positions and analysis set forth in the IAWC’s IB would be a violation of the due process rights of all other parties. Due process in administrative proceedings requires “the opportunity to be heard” and “the right to cross-examine adverse witnesses.” Gigger v. Bd. of Fire & Police Comm’rs of City of East

St. Louis, 23 Ill. App. 2d 433, 439 (4th Dist. 1959); see also Abrahamson v. Ill. Dep't of Prof'l Reg., 153 Ill. 2d 76, 95 (1992); Balmoral Racing Club, Inc. v. Ill. Racing Bd., 151 Ill. 2d 367, 400-01 (1992) (“cross-examination is required in order to ensure that due process requirements are met”). The presentation of new arguments and evidence for the first time in briefing threatens to undermine the fundamental fairness of any proceeding. It is also well settled that the opportunity to confront opposing litigants is essential, because absent that opportunity litigants cannot test the strength of a factual evidence underlying an opposing party's assertion. See, e.g., Final Order, Commerce Comm'n v. Northern Ill. Gas Co.: Reconciliation of revenues collected under Coal Tar riders with prudent costs associated with coal tar clean up expenditures, Docket No. 02-0170 (Aug. 6, 2003) (no consideration given to expert qualifications submitted for the first time in reply brief on exceptions); Final Order, Commerce Comm'n: Re Adoption of a Comprehensive Electric Energy Plan, Docket No. 94-0066 (Feb. 23, 1995) (disregarding proposal raised for the first time in briefing because it was not “tested on cross-examination” and no party had the opportunity to respond). The opportunity to cross-examine witnesses is completely absent when new positions are revealed for the first time in post-hearing briefing. The violation of due process is even more egregious in the instant proceeding, where the Company does not rely on any Company witness for the new information, and in fact, the information is contrary to the Company's expert testimony included in the record.

Reference to the FERC order is inappropriate because it is not part of the record. More importantly, the arguments that IAWC makes in reliance on that order are not only

not supported by the record, they are contrary to IAWC's own evidence and accordingly should be stricken.²

III. Argument

In its IB, IAWC argues "IIWC/FEA/CUB used the two-stage FERC model in estimating a return on the market to derive a CAPM market risk premium" (IAWC IB, 12) and suggests "[i]f the FERC approach was reliable for this purpose, it is equally reliable for others." Id. As the sole source of authority for this new position, IAWC cites to Appendix B, IIWC/FEA/CUB Exhibit 1.0, pages 43-44.

The problems with this argument are both numerous and insurmountable. First, as noted, this argument is directly contrary to the expert testimony sponsored by IAWC. IAWC adamantly rejected the use of anything other than a constant growth stage model. IAWC's expert witness Mr. Moul specifically chose to use a constant growth stage analysis, rather than a non-constant analysis such as the two-stage growth analysis used by IIWC/FEA/CUB or the multi-stage analysis used by Staff. Mr. Moul testified that he did not use a non-constant growth rate because "the growth rates that [he] obtained from analysts' forecasts of earnings growth are sustainable." (IAWC Ex. 10.00, 21.) When asked if there is "anything inherently wrong with the non-constant DCF model," Mr. Moul unequivocally stated, "Yes. The non-constant DCF model is not widely used in regulatory proceedings." (IAWC Ex. 10.00R, 8.) Further, Mr. Moul *specifically rejected* the use of the approach IAWC now appears to advocate. When asked if he takes issue with [IIWC/FEA/CUB's] multi-stage DCF, Mr. Moul testified, "I do [take issue with this approach] ...there is no reason to deviate from the traditional single-stage DCF model

² While Staff believes that all references to the FERC Order should be stricken as unsupported by the record, Staff further objects to inclusion of IAWC's references to the FERC order as the references are taken out of context and misrepresent the entirety of the FERC order.

results for public utilities.” (IAWC Ex. 10.00R, 25.) When he was asked “is [IIWC/FEA/CUB’s] multi-stage DCF growth rate analysis correct?” Mr. Moul answered, “*It is not.*” Id. (emphasis added).

Further, IIWC/FEA/CUB’s expert Michael Gorman does not use “the two-stage FERC model” to estimate his market return for his CAPM as suggested by IAWC’s IB. (IAWC IB, 12.) The language in Appendix B IIWC/FEA/CUB Exhibit 1.0, pages 43-44, is not an endorsement of FERC methodology to derive “a *CAPM market risk premium.*” Id. Rather, Mr. Gorman discusses a two-stage model to develop the growth rate portion of his two-stage DCF analysis of the S&P500. Specifically, he states,

In applications of a two-stage DCF model, the Federal Energy Regulatory Commission (“FERC”) has endorsed the use of a two-step DCF model. FERC’s two-step DCF model develops a composite growth rate by giving two-thirds weight to the short-term growth rate made by consensus analysts’ growth rate estimates, and one-third weight to a GDP growth outlook.

(Appendix B IIWC/FEA/CUB Exhibit 1.0, 43-44.)

Mr. Gorman simply takes one facet of the multi-faceted approach adopted by FERC to calculate the growth rate portion of his two-stage DCF analysis; he *does not* use the two-stage FERC methodology to arrive at his market return. Mr. Gorman then used the results of his two-stage DCF analysis to derive one end of his market risk premium range for his CAPM analysis. Thus, on its face, IAWC’s argument for adoption of the FERC methodology is incorrect because no witness used the entire FERC methodology to calculate ROE. There is simply nothing to support the suggestion that, because one intervenor’s witness used one portion of the FERC’s approach for one purpose, it is fair game for IAWC to use the entire FERC analysis for another purpose, especially where, as here, its own witness rejected such a use.

Moreover, Appendix B IIWC/FEA/CUB Exhibit 1.0, pages 43-44, does not reference any order or ruling by the FERC, or even attempt to suggest that the two-stage approach adopted by the FERC is the only analysis or even the correct analysis. Rather, IIWC/FEA/CUB Witness Michael P. Gorman simply states, "...I will use a two-step DCF model on the S&P 500. The two-step DCF model is simpler than my multi-stage model described above because it simply apportions weights to the short-term growth rate and long-term rate for the development of a composite growth rate that is then used in a constant growth DCF study." Id.

IAWC cannot be heard to suggest the Commission should adopt the two-stage approach used by FERC when its expert witness categorically and repeatedly rejected the use of anything other than a constant-stage growth rate. It is more than disingenuous to suggest that somehow a multi-stage approach is now not only proper but necessary, simply because "Mr. Moul's are the only DCF results remotely in the range...indicated by the FERC's two-stage DCF model." (IAWC IB, 18.) "Statements of facts in briefs...should be supported by a citation to the record." Chicago & E.I. Ry. Co. v. Commerce Comm'n, 341 Ill. 277, 285 (1930). Mr. Gorman's testimony does not constitute a basis for IAWC to change course and now advocate for use of a two-step FERC DCF model – something no witness used - because to do so contradicts the record evidence offered by IAWC. Because there is no evidence in the record to support the Company's new positions, citations to the record are noticeably absent. In fact, since IAWC's own expert evidence urges rejection of a two-stage DCF model, the Company's argument that use of that model *supports* its ROE recommendation is improper, untimely, and disingenuous.

Moreover, there is no record evidence to support the Company's argument that the results obtained specifically by using a DCF model must be adjusted upward. (IAWC

IB, 14.) Indeed, Mr. Moul did not discount the result of his own DCF analysis, nor did he give it any less weight than he did other valuation methodologies. Rather, Mr. Moul averaged the results of his DCF analysis and CAPM. He then used a risk premium model and a comparable earnings approach to justify a recommendation higher than that average. (IAWC Ex. 10.00, 4.) By averaging the two results, IAWC gave the DCF analysis and CAPM results *equal* weight. This is clearly contrary to the company's suggestion that results of a DCF analysis should not be taken at face value (IAWC IB, 15).

IV. Motion to Strike

Following are those portions of IAWC's IB that Staff moves to strike.³ These statements do not constitute nor reflect evidence properly admitted into the record. Nor are they legal arguments upon which the Commission can base a decision. Johnson v. Lynch, 66 Ill.2d 242, 246 ("The argument of counsel cannot be considered evidence... [.]") Moreover, there is a distinct difference between a legal argument that applies prior Commission decisions or statutes to the facts at hand and the introduction of a new theory that should have been introduced through testimony, especially when that new theory contradicts the testimony that actually was offered. The following paragraphs should be stricken for the reasons set forth in the proceeding paragraphs, and specifically because they do not reflect, and in some cases are contrary to, the record evidence. Where appropriate, additional argument for deletion of a specific section is provided

1. On page 12, the following sentences: "These demonstrated anomalies have led the FERC to re-evaluate its approach to establishing DCF-based equity returns for entities under its jurisdiction. See *Order 531*, 147 FERC 61,234. As an institution

³ Staff does not seek to strike IAWC's IB in its entirety but rather only those elements that are clearly not supported by the record. Staff's decision not to move to strike any other particular assertion or portion of the brief should not be construed as a concession as to the validity or merits of any other portion of IAWC's IB.

of considerable technical skill and prestige, FERC's conclusions deserve attention."

FERC is a Federal entity regulating, among other things, rates of electric transmission utilities. There is no basis whatever to conclude that FERC decisions governing electric transmission rates are applicable to rate proceedings for Illinois water utilities. Moreover, IAWC does not attempt to merely cite or reference a FERC order but rather seeks to introduce legal argument based on a FERC order which is contrary to record and its own evidence in this case.

2. Beginning on page 12 with the sentence "If the FERC approach was reliable for this purpose it is equally reliable for others" and continuing up to and including the sentence "The long-term growth rate component of the FERC calculation is based on forecasted GDP growth" at the bottom of page 13.
3. Beginning at the top of page 14 with the sentence "FERC, however, does not give these growth rates equal weight" and continuing to the penultimate paragraph on page 14, up to and including the sentence "The Commission is therefore entitled to give this information the weight it believes it deserves."

Staff notes that this section includes a calculation using Staff's variables for growth rates, which are referenced in footnote 11 of IAWC's IB. However, IAWC does not discuss Staff's variables as they are presented in the record but instead manipulates those numbers using a formula that is outside the record and improperly raised for the first time in this brief. Thus, Staff moves to strike the footnote as well, as it footnotes a section that Staff moves to strike and, absent that section, the footnote lacks context.

4. Beginning with the final paragraph on page 14, with the sentence "FERC recognized that the DCF midpoint results fell below state authorized ROEs for electric distribution utilities" and continuing through the middle of page 15, up to and including the sentence "And here, as in *Order 531*, the record of anomalous capital markets abound, including well-informed judgment that future interest rates have only one direction to move – up.
5. The final paragraph before section e on page 15, starting with the phrase "Rather than simply take the DCF-implied rates at face value..."

6. Beginning on page 15, section e, with the phrase “Although the Staff and FERC application of the DCF are both multi-stage models...” and continuing to the top of page 16 up to and including the phrase “Like the FERC model,”
7. Beginning at the top of page 16, beginning with the phrase “And as FERC observed, long-term growth rates...” and continuing through the remainder of that sentence and the next sentence, up to and including the phrase “...is consistent with the growth rate evidence produced here.”
8. In the penultimate paragraph on page 16, the sentence “Although Mr. Moul’s approach is different than FERC’s, the similarity of results confirms that both approaches represent different methods of arriving at similar results for the investor-required ROE.”
9. In the final sentence on page 16, the phrase “as FERC recognized.”
10. At the top of page 17, “The FERC two-stage model approaches this limitation by giving analysts’ short-term growth rate projections more weight than long-term projections. *Order* 531, 147 FERC 16,234 at ¶ 17. Both methods address the same limitation presented by speculating about investors’ long-term growth projections.”
11. In the middle of page 17, “The FERC two-stage DCF does not contain an express leverage component, but the FERC approach in general focuses on the goal of capital attraction in light of investor requirements. *Order* 531, 147 FERC 16,234 at ¶ 50.”
12. In the middle of page 18, “Mr. Moul’s are the only DCF results remotely in the range of the 10.51% indicated by the FERC two-stage DCF model. The average of Mr. Moul’s DCF and CAPM results is 10.41%—remarkably close to what the ROE would be if the issue were in front of FERC.”

Not only is there nothing in the record evidence supporting an ROE analysis based on the FERC order, there is no evidence that a FERC finding has any relevance in this proceeding. The FERC is a federal agency that regulates energy utilities and its findings are not binding on or relevant to the Commission’s review of an Illinois water utility.

V. Conclusion

In Commission proceedings, motions to strike portions of briefs which raise new information for the first time after the evidentiary hearing is concluded are routinely granted. See e.g., *Order, Commerce Comm’n*, Docket No. 94-0067 (October 5, 1994)

(granting motion to strike brief in part where it advocated a position that was not previously identified, was prejudicial to the interests of other parties, and presented and relied upon information not contained in the evidentiary record); Cent. Ill. Pub. Serv. Co.: Proposed General Rate Increase, Docket No. 91-0193, Order (May 18, 1992) (granting motion to strike portions of brief discussing information raised for the first time in the brief). Here, IAWC raises a proposal for the first time in its Initial Brief, after the conclusion of evidentiary hearings, which is contrary to the record evidence. This is improper and should be stricken.

WHEREFORE, for all the reasons set forth above, the Staff of the Illinois Commerce Commission respectfully requests the Administrative Law Judges to strike the identified sections of the Initial Brief filed by Illinois American Water Company.

Respectfully submitted,

/s/

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